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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1968

Paul Penjaska and John Penjaska,

Appellants,

v.

Goodbody and Company,

Appellee,

APPELLEE'S MOTION TO DISMISS APPELLANTS' APPEAL

ON APPEAL FROM THE SUPREME COURT OF THE
STATE OF MICHIGAN

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APPELLEE'S MOTION TO DISMISS APPELLANTS' APPEAL

Appellee motions the court to dismiss appellants' appeal from the Supreme Court of the State of Michigan on the following grounds:

1. The appeal does not present a substantial Federal question.

2. The judgment of the courts of the State of Michigan rests on an adequate non-Federal basis.

APPELLEE'S JURISDICTIONAL STATEMENT

Appellee, Goodbody & Company, accepts the findings of fact as set forth in the Opinion of the Circuit Court for the County of Shiawassee, State of Michigan, and which findings of fact were affirmed by the Opinion of the Michigan Court of Appeals. The Opinion of the Trial Court and the Opinion of the Michigan Court of Appeals appear at pages 31 through 42 of the Brief filed in the United States Supreme Court by appellants Penjaska. Those facts clearly indicate that the State Courts had jurisdiction of the matter litigated.

Appellee is a copartnership authorized to do business in the State of Michigan. Between dates November 24, 1959--January 27, 1960, appellants purchased through appellee, 2500 shares of Studebaker-Packard when issued stock using a joint cash account for that purpose. Purchases were made by appellee at appellants' request. These purchases were made as follows:

November 24, 1959 purchased 500 shares at a market price of 17 5/8

December 3, 1959 purchased 1000 shares at a market price of 16

January 26, 1960 purchased 500 shares at a market price of 15 3/4

January 27, 1960 purchased 500 shares at a market price of 15

The account required margin of 25% in accordance with New York Stock Exchange Rules. Securities then held by appellee in appellants' account were pledged as collateral against the foregoing described transactions in compliance with Exchange requirements. This stock was purchased at appellants' request, on a declining market for such stock. Thus, at the date of the last purchase of such stock, January 27, 1960, appellants' account possessed sufficient margin. Thereafter, the market for the stock declined such that on March 8, 1960, appellee called for margin, requesting appellants to bring the account to margin. At that time appellants requested more time. On or about March 27 or March 28, 1960, appellants informed appellee that appellants did not think they would "come up with the money". Appellants were again informed that the account would have to be sold out on March 29, 1960 unless appellants met margin requirements. On March 29 appellants' account was sold out, resulting in a debt due and owing from appellants to appellee in the sum of $4,050.79. Appellants failed to pay that amount to appellee. An action was commenced in the Circuit Court for Shiawassee County, Michigan, that being the place of residence of appellants, by Summons and Declaration in that Court. The

Declaration alleged generally that appellants were indebted to appellee in the amount stated rising out of stock market transactions herein described, and declaring upon common counts for the indebtedness.

The margin on said account remained sufficient until on or about February 3, 1960 when the margin account call was made as before stated; appellants asked for more time and then finally advised appellee that their margin deposit would not be forthcoming.

Although the account sufficiently met margin requirements at the onset, the decline in the stock market price of said stock caused the account to fall below margin, necessitating a call for margin.

It apparently is the position of appellants Penjaska that the failure of appellee to make more timely call for margin violated the rules of the New York Stock Exchange and the Federal Securities Exchange Act of 1934, as amended. It is apparently the position of the appellants that by refusal to pay the margin call, they thereby can force a violation of the Securities Exchange Rules and the Federal Exchange Act of 1934, as amended, thereby rendering their agreements, contracts and the transactions herein described, all void by reason of the provisions of

Section 27, Chapter 2B of the Securities Exchange Act of 1934 (being also 15 United States Code Annotated, Page 410, §78aa).

QUESTIONS PRESENTED

Do the United States Courts have exclusive jurisdiction of the subject matter raised and presented by appellants?

(A) Where margin on an account is sufficient at onset but due to stock market decline the account goes below margin, and the broker calls for margin which the customer declines to pay, has a violation of the Stock Exchange Rules and Federal Securities Act occurred which in and of itself grants exclusive jurisdiction to the Federal Court?

(B) If it be assumed that the broker failed to make a timely call for margin, as described by appellants, does such failure to make timely call for margin thereby grant exclusive jurisdiction to the Federal Courts because of any violation of Stock Exchange Rules or of the Securities Exchange Act of 1934?

ARGUMENT

The Federal Securities Exchange Commission is authorized under the Securities Exchange Act of 1934 to adopt rules and regulations which among other things, may be adopted with respect to setting

requirements for minimum deposits on margin accounts (Section 19 (b) (12) - U.S. Code Annotated, pages 361-363). Likewise, stock exchanges may adopt such rules governing its members as may seem advisable. Rule 431 of the New York Stock Exchange requires minimum deposit of 25% of a when issued security. Appellants reason from the foregoing that since Section 19 (b) of the Securities Exchange Act of 1934 generally requires a minimum deposit on margin accounts, and since said rule of the Stock Exchange was allegedly adopted in conformity with Section 19 (b) of the Securities Exchange Act of 1934, a violation of 431 of the New York Stock Exchange would necessarily be a violation of the Securities Exchange Act of 1934, Section 19 (b). Therefore, appellants have reasoned that the State Courts have no jurisdiction.

Chapter 2B of the Securities Exchange Act of 1934 was designed to cut out sharp practices and fraudulent schemes involving securities (Errion v. Connell, C. A., Washington, 1956, 236 F 2d 447). The test generally used in determining whether or not the Federal Courts do have exclusive jurisdiction over a particular action under the provisions of the Federal Securities Exchange Act of 1934 is cogently stated in Howard v. Furst, 238 F 2d 790 (1956). In that case, Judge Medina quotes with approval the opinion of Justice Cardozo in Gully v. First National Bank in Meridian, 299

U. S. 109 as follows:

> "As in problems of causation, so here in the search for the underlying law. If we follow the ascent far enough, countless claims of right can be discovered to have their source or their operative limits in the provisions of a federal statute or in the Constitution itself with its circumambient restrictions upon legislative power. To set bounds to the pursuit, the courts have formulated the distinction between controversies that are basic and those that are collateral, between disputes that are necessary and those that are merely possible. We shall be lost in a maze if we put that compass by."

Judge Medina, in applying the foregoing rule or test stated:

> "Applying this test, it is clear to us that every essential element of Appellants' case depends upon the common law and the Statutes of the State of New York."

These holdings point out that the Federal Court did not have jurisdiction since the appellants claims were mere excrescence or superfluity, tacked onto what otherwise was sufficient allegations of a claim for relief under the Act. The

rule otherwise stated means that the Federal statutes relied upon by appellants Penjaska must be an essential element of appellants' case, and appellants' reliance thereon must be of such a connection that it will be supported if the Federal law is given one construction and defeated if it receives another. (Gully v. First National Bank in Meridian, 299 U. S. 109).

Appellee's pleadings and Complaint in the State Courts constituted an action in debt and was upon the common counts for debt. These were counts over which the Trial Court of the State of Michigan had jurisdiction. The Answer and Counter Claim of appellants Penjaska in effect charged appellee with breach of contract and carelessness and negligence. There the issue was joined. Up to that point it was clear that the State Court had jurisdiction to determine a contract relationship between the parties and to determine whether or not the contract had been breached by either of the parties. Such matters are basically within the jurisdiction of the State Court. However, appellants Penjaska sought, and now seek, to extend the theory of their case so that it includes reference to the Securities Exchange Act of 1934, thereby attempting to give the Federal Courts exclusive jurisdiction of this matter. Appellants have tacked the provisions of the Securities Exchange Act

of 1934 on to their case through mere excresence and superfluity, in hopes that the United States Supreme Court will see fit to review the matter. Essentially, the basic claim of appellants Penjaska is that the broker was not astute enough to call for margin within the time during which appellants felt it should have been called for. Such a claim constitutes either a charge of ordinary negligence or a charge of breach of contract, which charges and allegations can be resolved in a State Court exercising its jurisdiction. The fact that appellants Penjaska are able, through an elongated reasoning process to collaterally connect their claim and defense to the Federal Securities Act of 1934, does not give exclusive jurisdiction of the matters involved to the Federal Court (Howard v. Furst, 238 F 2d 790 (1956) (Beury v. Beury, 127 Fed. Supp. 786).

In the case of Rospigliosi v. Clougher (1950) (46 South. 2d 170) (certiorai denied, 71 Supreme Court 81), the Supreme Court of the State of Florida held that provisions of the Securities Exchange Act insofar as it refers to contracts in violation thereof being void, means that such contracts may be void only if they violate the rules under the Federal statute; a violation of the New York Stock Exchange Rules does not render a contract void. An alleged

violation of the New York Stock Exchange rule does not thereby give exclusive jurisdiction to the Federal Courts. Remedies provided by State statute and State common law are sufficient.

The case of Colonial Realty Corporation v. Bache & Co. (United States District Court, Southern District of New York, no. 63, Civil 2240 - March 20, 1964--358 F 2d 178) involved facts where a customer brought suit against a broker for conduct allegedly not consistent with provisions of the Securities Exchange Act. The customer alleged that selling securities in a margin account was a violation of a written agreement not to do so unless the equity fell below margin requirements. The customer contended that violation of the Securities Exchange Rule also was a violation of Section 27 of the Federal Securities Exchange Act. The Court held that no Federal claim had been pleaded under the Exchange Act. The Court also observed that:

> "Almost any transaction with which a customer might not be satisfied, whether it violates the state law or not, might be characterized as violating such principle (assuming plaintiff's argument is correct). Furthermore, because the jurisdiction of the Federal Courts are exclusive under Section 27, the State Courts would be ousted of juris-

> diction of actions heretofore grounded upon state law alone if the contention of the plaintiff was accepted. This Court will not infer that Congress intended such drastic results without having explicitly so provided."

The Court, in Colonial Realty Corporation v. Bache & Co., cited with approval the case of Howard v. First National Bank, 238 F 2d, 790 at page 793.

If the contentions of appellants Penjaska are correct, it would mean that the Securities Exchange Act of 1934 ousted the State Courts of jurisdiction of actions heretofore grounded upon state law. That this was not the intention of Congress when it enacted the Securities Exchange Act of 1934 is clear from the ruling in the foregoing cases.

Appellants also argue that Rule 431 of the New York Stock Exchange Act regarding margin accounts is a rule which the Exchange had to enact because of the provisions of Section 19 (b) (12) of the Federal Securities and Exchange Act. The latter section simply provides, with respect to margin, that the Commission is authorized to request a Stock Exchange to effect its rules regarding many things and under Part 12 thereof, regarding minimum deposits on margin accounts. Section 19 (b) (12) does not purport to set specifications concerning the exact amount of

any such deposits or to determine by iron clad rule the preciseness or exactness of the method of handling of circumstances as they may arise in stock market dealings between a broker and customer. Significantly, the Securities Exchange Act requires that registered members of an exchange shall have rules. Yet the alleged violations of the rules of a Stock Exchange certainly do not oust the State Courts of jurisdiction. Under Section 27 of the Securities Exchange Act, the Board of Governors of the Federal Reserve System may from time to time with respect to all or specified securities or transactions, prescribe such margin requirements for initial extension or maintenance of credit as it may deem necessary or appropriate for the accommodation of commerce and industry, having due regard for the general credit condition of the country (15 U. S. Code Annotated, pages 246-247). Although the Sections of the Securities Exchange Act referred to make reference to the establishment of margin regulations, none of said sections attempt to set with exactitude the specifications of the margin requirements. This is left to the exchange as in the case of the New York Stock Exchange. The specifics governing margin, as may be required from time to time, are therefor set and determined by the rules of the New York Stock Exchange. In the case at bar, that rule is rule 431 requiring a minimum deposit of 25% on a when issued security. That rule was promulgated by

the New York Stock Exchange, and as in the case of Colonial Realty Corporation v. Bache & Co., supra, was enacted by the New York Stock Exchange pursuant to the direction contained in the Securities Exchange Act of 1934. It is noted that in Colonial Realty Corporation v. Bache & Co., the alleged violation of such rule of the New York Stock Exchange was held not to be a violation of the New York Stock Exchange Act which would thereby give jurisdiction to the Federal Courts. The direction of the Securities and Exchange Act of 1934 to the effect that exchanges shall promulgate regulations for themselves and their members so as to promote just and equitable principles of trade does not mean that violation of an alleged just and equitable principle of trade by a broker necessarily gives exclusive jurisdiction to a Federal Court. Yet, the Federal Securities and Exchange Act of 1934 directs that the stock exchanges adopt such rules. The Act does not purport to define or give the exact specifications as to what constitutes just and equitable principles of trade. However, this does not mean that an aggrieved party can merely allege violation of the Federal Securities and Exchange Act in that he was not dealt with on a just and equitable basis, and thereby place the litigation exclusively within the jurisdiction of the Federal Courts. By the same reasoning, although the Federal Securities and Exchange Act directs registered

exchanges to adopt rules and regulations concerning margin, an allegation by a party that his broker violated the rule of the New York Stock Exchange in that regard does not mean that the broker has also violated the Federal Securities and Exchange Act of 1934, nor does it by any means suggest that only Federal Courts may hear the aggrieved party's cause. As the Court stated in Rospigliosi v. Clougher, supra:

> ". . . But that does not mean that any rule or regulation which the exchange considered necessary becomes a rule under the statute, the violation of which would amount to a transgression of that law. It simply means that the exchange may have as many rules as it considers necessary to just operation. The provision of the Act as to any contract made in violation of any rule thereunder and the performance of any contract amounting to a violation of a rule thereunder refers distinctly to rules under this chapter (under the statute) and not to rules of an exchange which have been approved by the Securities and Exchange Commission."

The astuteness of the appellants Penjaska in attempting to bring their case within the complete purview of the Federal Securities Exchange Act of 1934,

and to contend therefrom that the Federal Courts had exclusive jurisdiction, is based entirely upon the fact that at the commencement of their account with their broker, there was sufficient margin, but the value of the when issued securities declined on the market after the account was open. When the broker called for margin on a declining market, the appellants Penjaska refused to cover the margin and the account did fall below margin. On that score, appellants Penjaska says that the Federal Securities and Exchange Act of 1934 was thereby and at that point violated, and therefore the Federal Courts had exclusive jurisdiction because appellants Penjaska filed an Answer and Counter Claim in the State Trial Court, thereby destroying the jurisdiction of the State Courts. In the alternative, appellants Penjaska plead and claim that the broker, appellee, was negligent and careless in that he failed to make a timely call for margin. If that were true, this could be an act of negligence or carelessness or breach of contract, the import of which is clearly triable in the State Courts. But it is the attempt of appellants Penjaska, through excrescence and superfluity, to connect their argument with the Federal Securities Exchange Act. If we follow that ascent far enough, countless claims of right can be discovered to have their source and operative limit in the provisions of a Federal statute or in the Constitution itself. To

set bounds to that pursuit, the Courts have formulated the distinction between controversies that are basic and those that are collateral, between disputes that are necessary and those that are merely possible (Howard v. Furst 238 F 2d 790). Every essential element of appellants' case depends upon the common law and the statutes of the State of Michigan. The fact that the claim of the appellants may be discovered to have its source or operative limit in the provisions of a Federal statute does not give the Federal Courts exclusive jurisdiction. Appellants raise a dispute which is "merely possible", but which dispute, as placed within the purview of the Federal statutes as appellants placed it, does not rely for the basic solution upon that statute.

CONCLUSION

For the reasons stated, appellants' appeal presents no substantial Federal question, and further, the judgment of the courts of the State of Michigan in this case rests on adequate non-Federal basis. The appellee motions this Court to dismiss appellants' appeal.

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